The Pulse of the Profession™

DEFINING OUR ROLE IN A CHANGING LANDSCAPE

NORTH AMERICAN REPORT – OCTOBER 2013

The Institute of Internal Auditors

Audit Executive Center®

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DISCLAIMER

ABOUT THIS DOCUMENT

The information included in this report is general in nature and is not intended to address any particular individual, internal audit function, or organization. The objective of this document is to share information and other internal audit practices, trends, and issues. However, no individual, internal audit function, or organization should act on the information provided in this document without appropriate consultation or examination.

ABOUT THE AUDIT EXECUTIVE CENTER

The IIA's Audit Executive Center is the essential resource to empower CAEs to be more successful. The Center's suite of information, products, and services enables CAEs to respond to the unique challenges and emerging risks of the profession. For more information on the Center, visit www.theiia.org/cae.

INTRODUCTION

The IIA's Audit Executive Center conducts the North American Pulse of the Profession Survey to assess the state of the internal audit profession. This survey looks at trends and emerging issues in the internal audit profession within the United States, Canada, and the Caribbean. Last year, the survey results indicated the strongest outlook for internal audit resources seen since the 2008 economic downturn. Continuing this trend, the 2013 survey suggests that the vast majority of the 428 CAEs and others in audit management roles who responded to this recent Pulse survey expect that their staff and budget resources will increase or stay the same in 2014.

With resource levels stabilizing close to pre-recession levels, the focus for internal audit seems to have settled into more diversified audit coverage than would have been seen a few years ago. The survey results indicate that audit departments are expecting a greater focus on compliance risks and less emphasis on Sarbanes-Oxley. At the same time, limited coverage of strategic business risks suggests a misalignment with the priorities of executive management and audit committees. "Historically, internal audit has witnessed that stakeholder expectations are a moving target," states IIA President and CEO Richard Chambers. "Even if we are aligned today, those expectations may change tomorrow." Chambers goes on to say that "at the end of the day, stakeholders expect us to be risk-based, and if we are not aligned with their priorities, then I think there is a risk that we will fail to meet their expectations."

This year, as in previous years, The IIA focused a portion of the survey on emerging issues that affect the practice of internal auditing. This survey introduced two focus areas:

- 2014 Requirements of the U.S. Affordable Care Act and anticipated risks.
- Preparedness for COSO 2013 *Internal Control–Integrated Framework* implementation.

Responses pertaining to the U.S. Affordable Care Act suggest that a potential expectation gap is emerging related to internal audit's ability to help stakeholders understand their associated risks. In contrast, survey results regarding COSO 2013 implementation indicate that internal audit departments that are implementing the revised framework by December 2014 foresee an easy transition.

SURVEY RESULTS AT-A-GLANCE

The IIA Audit Executive Center's 2013 North American Pulse of the Profession Survey of 428 North American internal audit professionals yielded the following overarching results:

1. The outlook for internal audit resources remains strong with steady increases in budget and staff levels and fewer decreases in some areas than in previous years.
2. One area of misalignment with stakeholder priorities appears to be strategic business risk.
3. Compliance risks are predicted to elicit greater audit coverage in 2014, pushing ahead of competing risk areas.

SURVEY DEMOGRAPHICS IN A NUTSHELL

The IIA Audit Executive Center's 2013 North American Pulse of the Profession garnered responses from 428 CAEs and others in audit management roles within North American organizations, varying widely in type, size, and industry sector.

Publicly traded organizations comprise the largest group of respondent organizations (38 percent). Privately held organizations and public sector entities also represent a significant portion of respondents — 27 percent and 23 percent, respectively. In addition, 14 percent of all respondents work in Fortune 500 companies.

The survey also shows a wide variation in staff size among respondent organizations, ranging from one person (11 percent) to more than 100 people (3 percent). The largest segment (38 percent) report staff sizes between two and five auditors.

Participants represent more than 26 industries, with the highest representation from the financial services industry (22 percent). Other industries that participated at notable rates include insurance (8 percent), health services (8 percent), manufacturing (7 percent), and education (7 percent).

Figures may exceed 100 percent due to rounding.

OUTLOOK FOR INTERNAL AUDIT REMAINS STRONG

A year ago, the Pulse survey reported the most optimistic forecast for internal audit budget and staffing since 2008. This year, the trend continues and by some measures predictions for 2014 are more positive than predictions were for 2013. As shown in Table 1, 36 percent of all respondents indicated that their budgets will increase in 2014, 54 percent stated budgets will remain stable next year, and only 10 percent expect budgets to drop. In terms of staffing, 25 percent of survey participants expect staff levels to increase in 2014, 72 percent expect staff levels to remain stable, and only 4 percent expect staff levels to decrease next year — this is more positive than the outlook for 2013 by all measures. Fortune 500 participants reported a similar outlook — 37 percent of Fortune 500 respondents indicated that budgets will increase in 2014 and 32 percent are anticipating the addition of more internal audit staff.

Equally important to note is the trend of actual budget and staffing over the years. Table 2 shows that budget and staff levels in 2013 are stronger than every previously recorded year, including 2008. In the context of predictions for 2014, internal audit can expect growing resources for budget and staffing.

Table 1. Projected Resource Changes from 2013 to 2014

	Budget			Staff		
	Increase	Stable	Decrease	Increase	Stable	Decrease
All Respondents	36%	54%	10%	25%	72%	4%
Fortune 500 Respondents	37%	53%	10%	32%	59%	9%

Source: The IIA's North American Pulse of the Profession Survey, September 2013.

Table 2. Comparison of Internal Audit Resources Since 2008

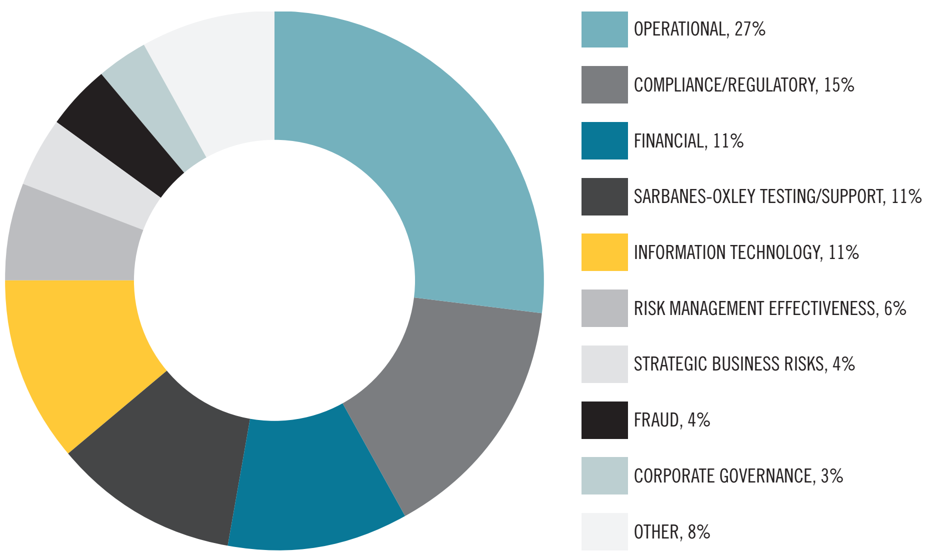
	Budget			Staff		
Year	**Increased**	**Stable**	**Decreased**	**Increased**	**Stable**	**Decreased**
2008	36%	50%	14%	22%	70%	8%
2009	27%	44%	29%	20%	61%	19%
2010	32%	40%	28%	17%	67%	17%
2011	31%	50%	19%	18%	69%	13%
2012	37%	46%	17%	21%	65%	14%
2013	37%	52%	12%	23%	70%	7%

Source: IIA's Emerging Trends and Global Pulse of the Profession surveys, 2008 – 2013.
Note: This is data from the North American respondents of our global surveys.

STRATEGIC BUSINESS RISK: OPPORTUNITY TO REALIGN WITH STAKEHOLDER PRIORITIES

For the majority of respondents, strategic business risks consistently receive less coverage than competing risk areas. As in projected audit plans for 2013, plans for 2014 (Figure 1) indicate that the largest portion of audit coverage will fall on operational risks (27 percent), followed by compliance (15 percent), general financial (11 percent), Sarbanes-Oxley (11 percent), and IT (11 percent). Audit coverage on strategic business risks, as well as risk management effectiveness, represent a smaller portion of the average audit plan — 4 percent and 6 percent, respectively.

Figure 1. Composition of Expected Audit Plan Coverage in 2014



Source: The IIA's North American Pulse of the Profession Survey, September 2013.
Note: This is a summary of the averages from all respondents.

The limited coverage on strategic business risks appears misaligned with respondents' assessment of the importance of this area to stakeholders. For example, 53 percent of respondents identify strategic business risks among the top five priorities for their audit committee and 71 percent identify it as a top priority for executive management (Table 3). Yet the majority of respondents (57 percent) indicate no coverage of strategic business risks in their 2014 audit plan. Among respondents from Fortune 500 companies, 63 percent identify strategic business risks as a top priority for their audit committee, 83 percent identify it as a top priority for executive management (Table

4), and 50 percent of respondents in this group indicate no coverage of strategic business risks in their 2014 audit plan. If internal audit recognizes strategic business risk as a priority for executive management and the audit committee, why don't more audit plans have coverage of strategic business risks?

"The problem," suggests Richard Anderson, clinical professor at DePaul University in Chicago and former managing partner for PricewaterhouseCoopers LLP's internal audit services, "is that too many audit groups operate with a bottom-up risk assessment, but you can only identify business risk if you look from the top down and ask, 'What are these people trying to accomplish, and what are the events or issues that could prevent them from meeting their objectives?'"

Table 3. Comparison of Top Risk Areas for the Audit Committee and Executive Management – All Respondents

% Identified as Audit Committee Top Risk Area		% Identified as Executive Management Top Risk Area	
Compliance/Regulatory	68%	Operational	74%
Operational	68%	Strategic Business Risks	71%
Strategic Business Risks	53%	Compliance/Regulatory	53%
Information Technology	45%	Financial	39%
Financial	44%	Information Technology	39%
Risk Management Effectiveness	34%	Cost/Expense Reduction	37%
Corporate Governance	23%	Risk Management Effectiveness	26%

Source: The IIA's North American Pulse of the Profession Survey, September 2013.

Table 4. Comparison of Top Risk Areas for the Audit Committee and Executive Management – Fortune 500

% Identified as Audit Committee Top Risk Area		% Identified as Executive Management Top Risk Area	
Compliance/Regulatory	73%	Strategic Business Risks	83%
Strategic Business Risks	63%	Operational	77%
Operational	55%	Compliance/Regulatory	70%
Information Technology	47%	Information Technology	40%
Financial	32%	Cost/Expense Reduction	33%
Risk Management Effectiveness	30%	Financial	30%
Corporate Governance	30%	Risk Management Effectiveness	17%

Source: The IIA's North American Pulse of the Profession Survey, September 2013.

COMPLIANCE RISKS ARE PREDICTED TO ELICIT GREATER AUDIT COVERAGE

Over the years, the internal audit profession has adapted to the challenges of an ever-changing business environment. As priorities continue to change, this most recent Pulse of the Profession survey suggests that compliance risks are predicted to elicit greater audit coverage in 2014 than coverage of general financial auditing, Sarbanes-Oxley coverage, and IT auditing. Among respondents to the survey, compliance audits make up the second largest area for 2014 audit coverage, representing 15 percent of audit plans where general financial, Sarbanes-Oxley, and IT each represent 11 percent. As Table 5 shows, a high percentage of respondents also predict increased focus on compliance in 2014. More specifically, 34 percent of respondents indicate that they expect an increase in focus on compliance in 2014 and only 7 percent indicate a decrease. When comparing this to other areas of focus, the increase on compliance comes second only to predictions of increased focus on risk management effectiveness.

As mentioned previously, survey respondents indicate that compliance is among the top five risks for both the audit committee and executive management. When comparing this to the 2012 survey, the 2013 results suggest that internal audit sees compliance as more important to their audit committee and executive management than it was last year. For instance, Table 3 shows that 68 percent of respondents believe compliance is among the top five risk areas for their audit committee, which is up 9 percentage points from the 2012 survey. Pertaining to executive management, 53 percent of respondents believe that the C-suite considers compliance one of the top five risk areas next year; this is up 7 percentage points from the 2012 survey.

Staying on top of compliance risks requires an internal audit function that is informed on regulatory activity bound to affect audit plans in the coming year. Proactive measures to get ahead of these regulatory waves demonstrate the kind of value that internal audit can bring to stakeholders. Being cognizant of the effects of regulatory activity allows internal audit to demonstrate foresight when it comes to compliance risk, or as The IIA's Chambers says succinctly, "Today's legislative headlines are tomorrow's compliance risks."

Table 5. Changes in Audit Focus

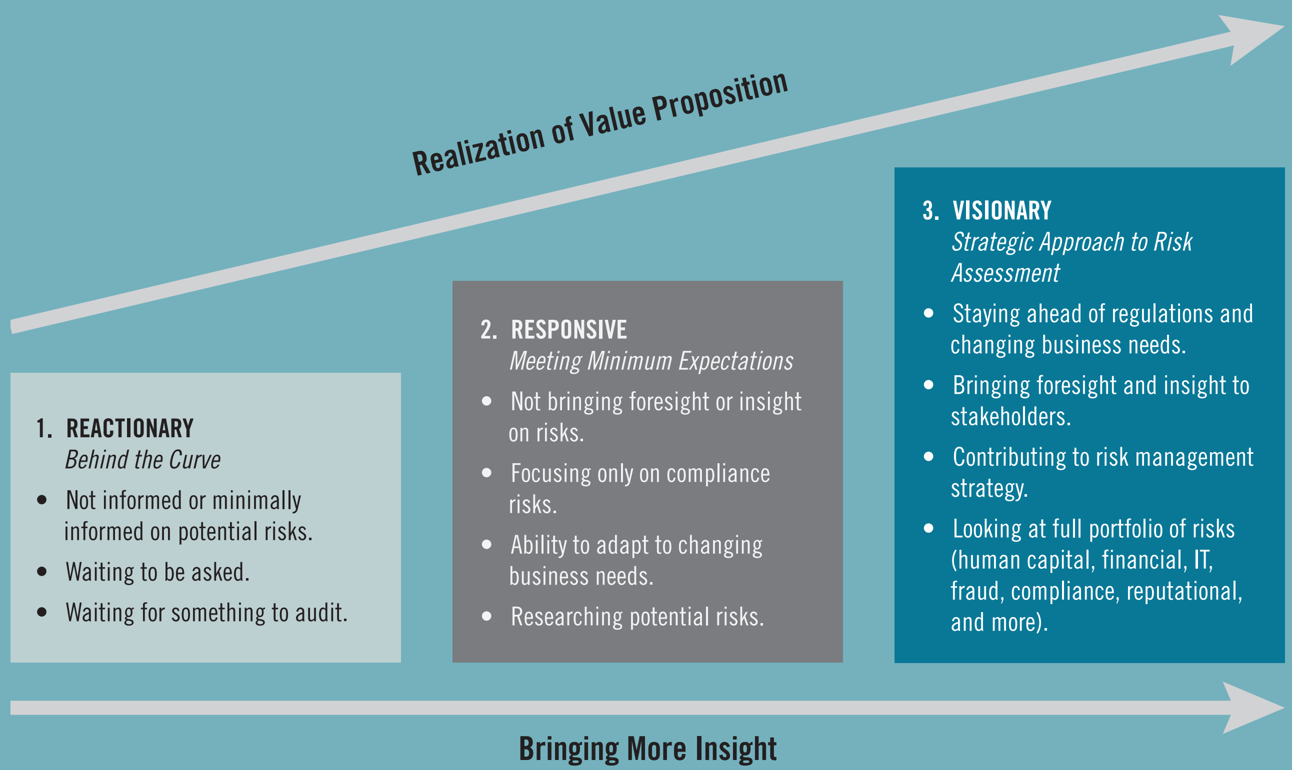
AREA OF FOCUS	INCREASE		NO CHANGE		DECREASE	
	All Respondents	Fortune 500	All Respondents	Fortune 500	All Respondents	Fortune 500
Risk Management Effectiveness	35%	36%	63%	63%	2%	2%
Compliance/ Regulatory	34%	36%	59%	62%	7%	2%
Information Technology	31%	27%	64%	69%	5%	4%
Operational	31%	33%	59%	60%	11%	7%
Strategic Business Risks	31%	39%	65%	59%	4%	2%
Corporate Governance	21%	23%	77%	77%	3%	0%
Third-party Relationships	20%	36%	74%	60%	6%	4%
Cost/Expense Reduction	15%	17%	79%	77%	6%	6%
Fraud	14%	18%	84%	82%	3%	0%
Financial	11%	13%	81%	80%	8%	7%
Sarbanes-Oxley Testing/Support	10%	11%	77%	64%	13%	25%
Crisis Management	6%	4%	86%	89%	7%	8%

Source: The IIA's North American Pulse of the Profession Survey, September 2013.

BIG REGULATION = OPPORTUNITY KNOCKING

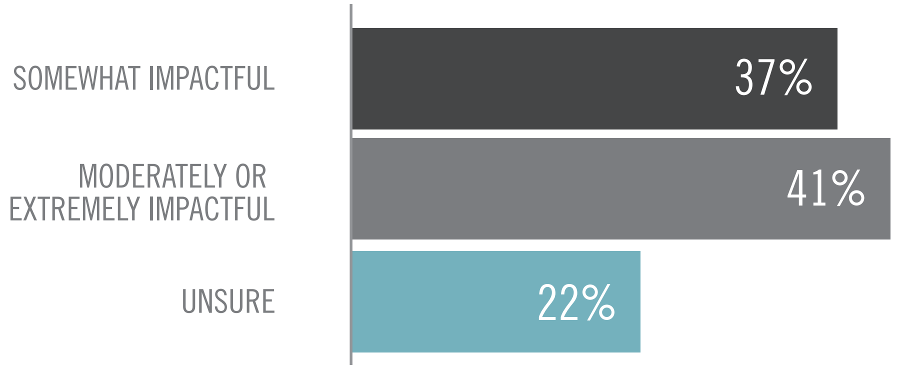
With many of the requirements of the U.S. Affordable Care Act (ACA) coming into effect in 2014, health care is an area where internal audit may see an increased focus on compliance in the coming year. Ongoing debate surrounding ACA creates a great deal of uncertainty regarding the impact of this legislation. Are auditors looking at what is happening in legislation? Have they started asking questions of the human resources, compliance, and operations leaders about the impacts and their organization's readiness to meet the challenges?

WHERE DO YOU WANT TO BE WHEN IT COMES TO THE RISKS ASSOCIATED WITH THE AFFORDABLE CARE ACT?



The 2013 North American Pulse of the Profession Survey explored the concerns surrounding ACA through a series of questions regarding the 2014 requirements of the legislation and anticipated risks. Results from the survey indicate that a potential expectation gap is emerging related to internal audit's ability to help stakeholders understand the risks associated with ACA and their organization's preparedness to mitigate those risks. Among respondents who noted that ACA would apply to their organization, 22 percent are unsure whether the 2014 requirements of the U.S. Affordable Care Act will affect their organization and 41 percent believe risks associated with the legislation will be moderately or extremely impactful on their organization (Figure 2); yet only 17 percent believe it will have a moderate or extreme impact on internal audit.

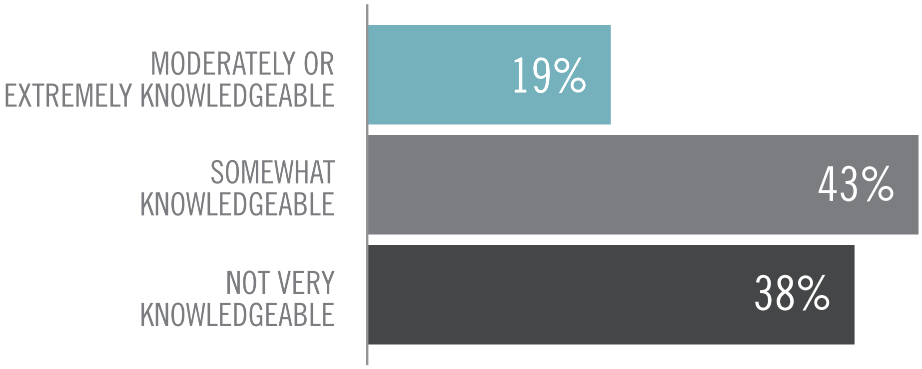
Figure 2. Assessment of the impact of the risks associated with U.S. Affordable Care Act on the organization.



Source: The IIA's North American Pulse of the Profession Survey, September 2013.

When it comes to familiarity of the legislation, respondents indicate they have limited knowledge of ACA. Among the participants who note that the U.S. Affordable Care Act would apply to their organization, 38 percent rate themselves as not very knowledgeable of ACA and another 43 percent rate themselves as only somewhat knowledgeable (Figure 3).

Figure 3. Self-assessment of knowledge surrounding the U.S. Affordable Care Act.



Source: The IIA's North American Pulse of the Profession Survey, September 2013.

At the same time, 17 percent of respondents for whom this legislation will apply agreed that their organization will likely act to mitigate risks associated with ACA by reducing or dropping health care benefits in the next one to three years. Another 21 percent of respondents were unsure if their company will be reducing or dropping benefits. For Fortune 500 organizations, the percentage of respondents that agreed that their company would likely mitigate risks through reduced benefits was 24 percent.

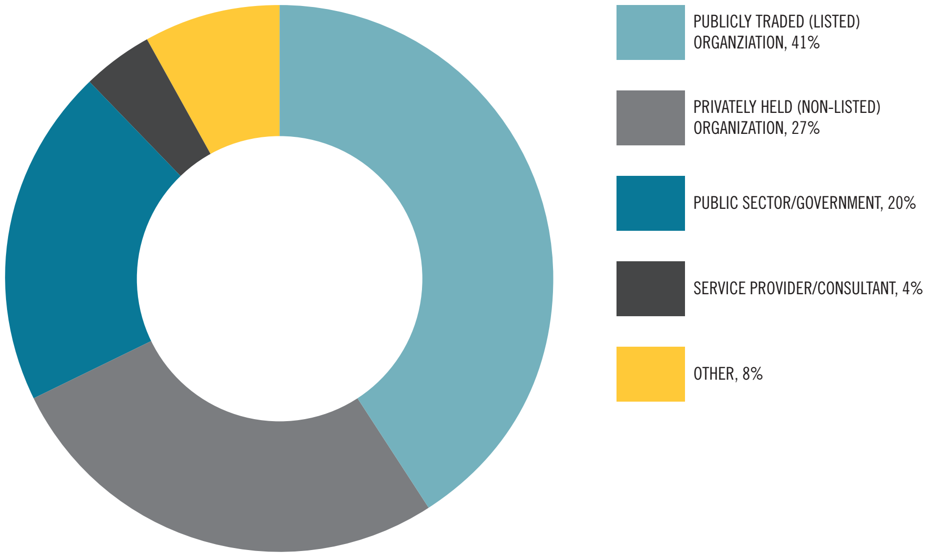
Another possible area of impact is employee attitude, suggests Carolyn Saint, 7-Eleven, Inc.'s CAE and chairman of The IIA's North American Board. Saint says CAEs need to understand how this is going to affect the full range of risks in their organization, including fraud. "Is ACA going to affect one leg of the fraud triangle, making fraud more likely to occur because this has caused employees to question their loyalty?" Saint expects that much of the impact of ACA will play out over time: "In a year, we may understand the effects better, but it will take quite awhile before this is the new normal."

ADOPTERS OF COSO 2013 INDICATE EASE OF TRANSITION

The second focus topic in the survey this year was preparedness for COSO 2013 *Internal Control–Integrated Framework* implementation. This survey topic shed light on the obstacles and opportunities surrounding transition to the revised framework. The survey results indicate that more respondents are looking to adopt or transition to COSO 2013 than previously used the 1992 COSO framework.

In a speech at the 32nd Annual Securities and Exchange Commission and Financial Reporting Institute Conference, U.S. Securities and Exchange Commission Chief Accountant Paul Beswick suggested that users of the COSO framework rely on COSO's recommendations for transition, which is to transition by Dec. 31, 2014. Apparently prompted by COSO's recommendation for transition, the majority of respondents (55 percent) from publicly traded companies indicate expected transition dates to COSO 2013 on or before December 2014. Additionally, the level of knowledge and preparedness surrounding COSO 2013 reported by respondent public companies suggests that most expect an easy transition.

Figure 4. Composition of Organization Type Respondents Planning to Use COSO 2013



Source: The IIA's North American Pulse of the Profession Survey, September 2013.
Note: This is data is from respondents who indicated that they plan to use the COSO 2013 framework.

As demonstrated by the composition of organizations types planning to use COSO 2013 (Figure 4), a diversity of organizations intend to implement the revised framework. Survey results also indicate that COSO 2013 is being adopted by more organizations than the 1992 framework and will be used for both financial and nonfinancial controls within those organizations. To this point, 87 percent of respondents to this survey plan to use the COSO 2013 framework compared to only 73 percent of respondents who use the 1992 COSO Framework. Speaking to the broad applicability of the framework, 29 percent of respondents who plan to adopt the 2013 framework plan to use it for their entire system of internal control.

One area of concern regarding roles and responsibilities as it pertains to COSO 2013 implementation is the large percentage of respondents who indicate that internal audit has overall responsibility for their organization's assessment and reporting on internal control or for COSO implementation. In particular, 45 percent of respondents who plan to adopt the framework indicate that their internal audit department has overall responsibility for their organization's assessment and reporting on internal control and 42 percent have overall responsibility for COSO implementation. With internal audit taking overall responsibility in these areas, CAEs need to ensure that management designs and implements the control processes and that their own objectivity is properly maintained.

Not surprisingly, the results from the survey indicate that public companies are more likely to transition to COSO 2013 by or before December 2014. No doubt fueled by the impetus to comply with Sarbanes-Oxley, 77 percent of respondents from public companies planning to adopt the framework indicate they will transition to COSO 2013 by or before December 2014. Furthermore, the survey results suggest that the majority of respondents from public companies are considerably knowledgeable about the revised framework and minimally concerned about transition. For example, 64 percent of respondents from public companies planning to adopt the revised framework indicate they are moderately or extremely familiar with the 17 principles of the COSO 2013 Framework (Figure 5). Conversely, Figure 6 shows that 71 percent respondents from public companies rate the expected impact of the COSO transition to their organization as not significant or only moderately significant.

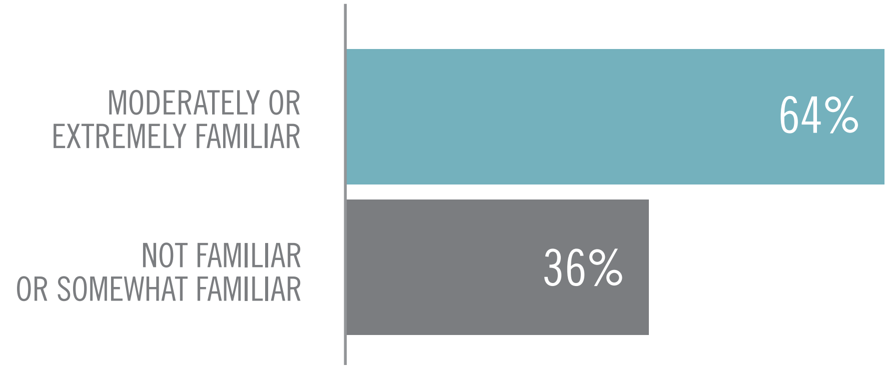
INSIGHT ON PREPAREDNESS FOR COSO 2013 INTERNAL CONTROL–INTEGRATED FRAMEWORK IMPLEMENTATION

Are companies that are not affected by Sarbanes-Oxley putting themselves at risk by not prioritizing transition to COSO 2013?

"Agreed to by a group of experts including a due process comment period and broad distribution around the world, the 17 Principles reflect careful consideration of today's operating, reporting and compliance environments. This principled-based structure allows all organizations, regardless of size, industry, maturity or ownership to be able to achieve effective internal control using different and customized control activities in order to conclude that all 17 Principles are present and functioning."

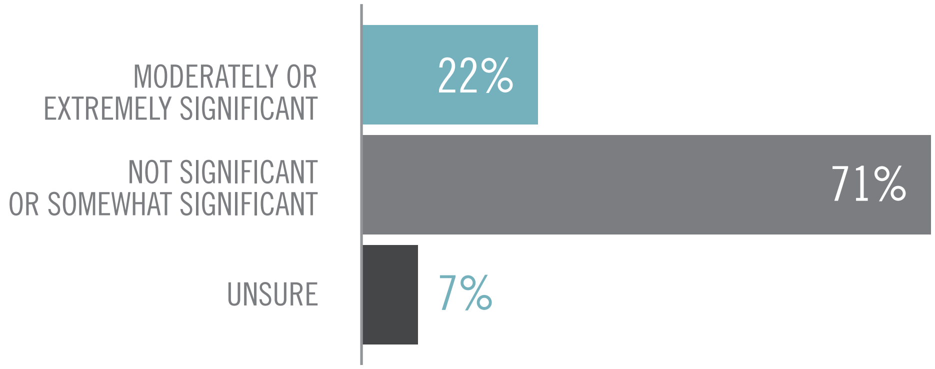
– Robert B. Hirth, Jr., Chairman Committee of Sponsoring Organizations of the Treadway Commission

Figure 5. Familiarity with the 17 principles of COSO 2013 among public companies planning to use the revised framework.



Source: The IIA's North American Pulse of the Profession Survey, September 2013. Note: This is data from respondents who indicated that they plan to use the COSO 2013 framework.

Figure 6. Assessment of impact among public companies planning to use COSO 2013.



Source: The IIA's North American Pulse of the Profession Survey, September 2013. Note: This is data from respondents who indicated that they plan to use the COSO 2013 framework.

The high confidence level suggested by these survey results resonates with the comment made earlier this year by COSO Chairman Robert Hirth, Jr. at an Audit Executive Center CAE roundtable: "If organizations have monitored changes appropriately and revised their systems of internal control regularly and effectively to address internal and external changes, they should experience less than a significant effort when transitioning to a revised framework. Of course, all organizations are different and thus each organization will experience a different level of transition effort."

HOW DO WE RISE TO THE CHALLENGE IN 2014?

Looking toward 2014, we are well positioned as a profession to tackle the challenges before us. Internal audit departments continue to see increased resources, suggesting greater realization of their value proposition. At the same time, audit plans reflect the growing velocity of regulatory compliance. Of course, there remain areas of opportunity — strategic business risk in particular.

With the growing importance of compliance efforts, one of the greatest opportunities facing the profession this coming year relates to the U.S. Affordable Care Act. To take advantage of this opportunity, internal audit cannot assume a reactive posture. This regulation challenges internal audit to become a visionary, proactive function in their organization.

For many organizations, next year also promises to bring more focus on their system of internal control. Early indicators suggest that the majority of organizations that will be required to implement the COSO 2013 *Internal Control–Integrated Framework* are moving steadily toward their December 2014 deadline. Due to the evolving nature of internal audit, CAEs need to stay ahead of the curve to manage challenges and opportunities facing their organization and their internal audit function. Yet this means more than understanding the compliance risks associated with the latest regulations; it requires that internal audit gain the business knowledge and the general awareness to provide foresight into factors that threaten the objectives of their organization.

Providing perspective into how organizations can rise to this challenge, 7-Eleven's Saint shares that her internal audit function incorporated the use of a value charter and metrics by which to measure factors that enhance professional competency. "The other thing that is key," states Saint, "is to know the company's business. How does the organization make money? How do the operations and logistics work? Combine this with professional competency and you'll ensure that internal audit is sought out."

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